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NO. 314

IN THE

Supreme Court of the United States

OCTOBER TERM, 1938

WICHITA ROYALTY COMPANY ET AL, *Petitioners,*

versus

CITY NATIONAL BANK OF WICHITA FALLS, ET AL,
Respondents.

Petition for Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit

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BAILEY—WICHITA FALLS

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The Petition of Wichita Royalty Company for the issuance of a Writ of Certiorari to the Circuit Court of Appeals, for the Fifth Circuit, respectfully represents:

I

SUMMARY OF THE MATTER INVOLVED

The Respondent, The City National Bank of Wichita Falls, sued Petitioner Upon notes in 1930 (R. 2070). Petitioner, a trust association, answered and filed a Cross Action setting up the former Trustee's breaches of trust in the matter of numerous checks by which trust moneys were transferred direct from the

trust account to the personal account of the Trustee and applied partly to the Bank and partly to the Trustee's personal use (R. 1884-1912; 2070). The case was decided by the Supreme Court of Texas upon the holding:

> "It appears conclusively that shortly after Peckham began making the transfer of trust funds to his personal account, he began making payments on his personal indebtedness to the Bank out of the ocmmingled funds. * * *
>
> "It will be noted that the Bank, in Adoue & Lobit case, was held liable not only for that part of the trust fund received in payment of the fiduciary's debt, but also for the $5,000.00 thereafter checked out by him to another. The Court on rehearing expressly refused to give controlling effect to the Bank's receiving part of the fund, basing the recovery of the $5,000.00 upon the sole ground that the act of the Bank in placing the trust funds to the personal account of the fiduciary, whence they were checked out for other than a trust purpose, was 'obviously wrongful', and that the bank 'must bear the resulting consequences.'
>
> "The Bank complains that the rule is harsh in view of the ration between the amount of business transacted and the amount of Peckham's default, and urges that it did not have actual knowledge of the defalcations. It cannot be heard to say after participation in Peckham's wrong to its own substantial advantage that the benefit received was relatively small, or that it was not consciously participating with him. * * *
>
> "In the case of Rischoff vs. Yorkville Bank,

supra, only two checks, one for $765.00 and the other for $1,000.00 were drawn on the account and applied to the debt due the bank. The bank received only $1,765.00 to be applied on executor's debt to it, but was held liable for $12,000.00 principal, and $3,000.00 interest. It was held liable for every check drawn on the commingled account after it received the first payment on its debt, some of which were issued and presented more than three years after the first application so made. * * *

"* * * The cases relied on by counsel for the Bank, holding on the particular facts of those cases that liability cannot be predicated upon the crediting of trust funds to the trustee's personal account, are distinguishable for the reason, among others, that in none of them was the transfer credited after the bank had been guilty of participating with the trustee in a known breach of trust.

"In the present case, the bank, after being charged with knowledge of Peckham's dishonest dealings continued to credit Peckham's personal account with checks drawn on the trust account, and persisted in its course of dealings with respect to the two accounts. Having incurred the burden of ascertaining whether subsequent expenditures made by the trustee from the commingled funds were for authorized trust purposes, it cannot effectively complain of the weight of that burden. * * * *

"All of these improper withdrawals and misapplications of trust funds took place after the Bank had participated with Peckham by accepting trust funds on his personal debts to the bank after Harrell was charged with knowledge thereof. * * * It was not necessary, in order to establish partici-

pation of the bank and Harrell with Peckham, to show actual knowledge on their part of Peckham's purposes as they relate to the various transactions in question. Steere vs. Stockyards Nat. Bank, supra. The Bank and Harrell had constructive knowledge of Peckham's dishonesty, and inquiry pursued with reasonable diligence would have disclosed the facts showing Peckham's lack of authority and breaches of trust. First Nat. Bank of Houston vs. Weiner (Tex. Civ. App.) 253 S. W. 615; Miller & Co. v. Hobdy (Tex. Civ. App.) 159 S. W. 96; Coder v. McPherson (C. C. A.) 152 F. (2) 951; Essex Nat. Bank v. Hurley (C. C. A.) 16 F. (2d) 427. * * *

"It is apparent from what has been stated that the amount of the bank's liability is the difference between the total amount of the deposits for which Packham's personal account received credit after he began commingling trust funds with his own on October 8, 1925, and the total amount of withdrawals therefrom which the Bank may show were used for authorized trust purposes. It conclusively appears that the bank is not entitled to credit for expenditures out of the commingled account for the purchase and improvement of Marlborough, or those transactions wherein Peckham acted in the dual role of buying as trustee for himself personally. * * * *

"* * * The amount of Harrell's liability to the trust is the aggregate amount of trust funds paid out on the transactions in question in which he was personally interested, and which Scannell subsequently repudiated with tenders as pleaded and shown. * * *

"The judgment of the trial court and Court of Civil Appeals on both the direct and cross-actions are reversed, and the case is remanded for another trial in accordance with instructions given herein."

The case was reversed and remanded by the Supreme Court of Texas for rendition of judgment upon the above quoted principles (R. 1884-1912) 127 Tex. 158; 89 S. W. (2d) 394.

Motion for Rehearing was overruled by the Supreme Court of Texas, without modifying the above holdings . 127 Tex. 158, 93 S. W. (2d) 143. The opinion in *Q. A. & P. Ry. Co. v. Wichita State Bank & Trust Co.*, cited by the Circuit Court of Appeals, was released the same day the Motion for Rehearing was denied in this case. In fact, the opinion in the Q. A. & P. case expressly approves the holding in the instant case. 127 Tex. 407, 93 S. W. (2d) 701.

The old bank became insolvent, new parties were made, and the case was removed to the federal court. On appeal the Circuit Court of Appeals remanded the case for special findings to be applied to principles of law differing in essential particulars from those decided by the Supreme Court of Texas above (R. 2073).

These differences were sharply drawn. The rule of the Bischoff v. Yorkville Bank case, employed as a yardstick by the Supreme Court of Texas, was expressly disapproved by the Circuit Court (R. 2082). In its place the so-called "bad faith" doctrine was invoked, on the holding that despite the Bank's direct receipt of a part of the diverted fund it could not be held for

subsequent withdrawals unless it had actual knowledge of them (R. 2081, 2082).

The Texas Court, following the lead of what it conceived to be the weight of the authorities and the better rule, passed over the Bank's acquiescence in the irregular transfers of funds from the trust account to the personal account of the trustee, but refused its sufference beyond the point where the Bank received its first benefit. Charged at that time with notice of the wrongful use of the transferred funds, the Bank could no longer presume that the trustee would thereafter withdraw them for legitimate trust purposes. Thence forward the several withdrawals from the personal account were to be treated as a unit and not as isolated transactions (R. 1894-1904). The Circuit Court, allowing recovery for the amounts received by the Bank, follows rigidly its test of "bad faith" and requires a finding of actual participation or knowledge by the bank covering the purpose and use of each withdrawal. The situation is left as it was before the Bank began to share in the fund. Each transaction is severed from those preceding it and, absent guilty knowledge in each, the bank is absolved (R. 2081-2082).

This basic difference in the principles pronounced by the two courts is carried forward in their respective holdings on the Bank's accounting liability. The Texas Court refuses to give the Bank credit for the trust funds withdrawn from the commingled personal account after the Bank's reception of payment and used in "those transactions wherein Peckham acted in the dual role of buying as trustee from himself person-

ally." (R. 1909.) Such transactions, being fraudulent as a matter of law, were properly repudiated by the succeeding trustee (R. 1904). Since, by its participation in the diverted fund, the Bank was subjected to the duty of seeing to a proper use of moneys subsequently checked out, it could not account for them through the dual dealings of the trustee (R. 1902, 1909). The Circuit Court takes sharp issue. It recognizes the voidable character of these transactions, but relieves the Bank from their consequences on the ground that the Bank could not question them when they were entered into. (R. 2080). The matter is made to turn upon the fact that the Bank was not a party to these lease transactions. The Texas Court, with an eye to the initial step—the wrongful transfers and withdrawals—declines to sever cause and result. That Court holds that after the Bank's acceptance of trust money from the commingled account it was obliged to investigate the purpose of later withdrawals before honoring checks drawn to the trustee or others. Its failure to discharge that obligation could not be excused by the fact that the Bank could not undo the wrongful transactions into which the money went.

The net result of these differences on the applicable law is that by the Circuit Court's decision recovery is limited (1) to the amounts actually received by the Bank (R. 2079); (2) the amounts represented by the checks payable to the Bank and not properly accounted for (R. 2081); and (3) such as were appropriated with the actual knowledge of the Bank (R. 2081). In striking an account the Bank is to be credited with sums in-

volved in all transactions between the trustee personally and his trust except his purported sale of Marlborough (R. 2080, 2083). This last is, of course, excluded for the obvious reason that it was completely beyond the scope of the trust, as evidenced by the written Declaration (R. 2083).

The Petitioner filed Motion for Rehearing on the sole ground that under *Erie Ry. Co. v. Tompkins*, 82 U. S. 787, the decision of the Texas Court in this case was binding in every particular upon the Circuit Court (R. 2091). The Motion was overruled by written opinion filed June 10, 1938 (R. 2094). Departure from the decision of the Supreme Court of Texas was admitted but justified on the ground that the Circuit Court sat as the appellate tribunal on removal from the State Court and was vested with power to redeclare the governing law. Speculating on what the Supreme Court of Texas would probably do, the decision by that Court in *Q. A. & P. Ry. Co. v. Wichita State Bank & Trust Company*, 127 Tex. 407, 93 S. W. (2d) 701, was construed as being in accord with the "general" law (R. 2096). The conclusion was that since the Circuit Court's original opinion stated the "general" law, it was therefore in line with the law of Texas (R. 2097). This weighing of probabilities ignores the essential fact that the Motion for Rehearing in the instant case was overruled by the Supreme Court of Texas on the same day that the Court's opinion was delivered in *Q. A. & P. Ry. Co. v. Wichita State Bank & Trust Company, supra.* In a short written opinion the Texas Court expressly reaffirmed all principles set forth in its original opinion.

Wichita Royalty Company et al v. City National Bank of Wichita Falls et al, 127 Tex. 158, 93 S. W. (2d) 143. Satisfaction with such principles is particularly noted by Justice Critz in the *Quanah* case. *Q. A. & P. Ry. Co. v. Wichita State Bank & Trust Company*, 127 Tex. 407, 93 S. W. (2d) 709.

QUESTIONS INVOLVED

1. Whether the Circuit Court of Appeals was bound by the law of Texas, as defined in this case by the highest Court of that State prior to removal of the cause.

2. Whether it was permissible for the Circuit Court of Appeals to ignore the decision of the Supreme Court of Texas in this cause and determine the applicable State law by a forecast based on a contemporaneous decision involving different, though related, principles, as to what the State Court might probably do were the case again presented for decision.

REASONS RELIED ON FOR ALLOWANCE OF THE WRIT

1. *In rendering its decision the Circuit Court decided an important question of local law in a way probably in conflict with the applicable local decisions.*

On original hearing the Circuit Court denied Petitioner's claim that the decision of the Texas Supreme Court became the law of the case, binding upon the Federal Court after removal (R. 2076). An effort was made to distinguish *Williams v. Conger*, 125 U. S.

397, on the ground of its being a land case in which the State law had peculiar weight (R. 2077). In recognizing the compulsion of the decisions of the Supreme Court of Texas, this Court did not so qualify its holding in the Conger case:

> "The Removal of the cause from the State Court does not put us in the position of a Court of review over the Supreme Court of Texas. When it acted, it was the highest court that could act in the cause, and stood in precisely the same position that we now stand. Its action must be accepted by us as that of a court having plenary and final jurisdiction."

Wholly aside from the rule of *Erie Railroad Company v. Tompkins*, 82 U. S. 787, the Circuit Court disregarded what was "local" law because it was the "law of the case," and thereby threw itself into direct conflict with the decision of this Court in *Williams v. Conger, supra.*

The opinion on rehearing but served to aggravate the Court's position. Its claimed right to differ with the State Court's decision and to act as that Court's successor in modifying that decision is reiterated (R. 2095-96). In deference to *Erie Railway Company v. Tompkins, supra*, any effort to deviate from the law of Texas is disclaimed (R. 2095). For the first time it is suggested that the Texas Supreme Court's decision in this case does not represent the law of Texas (R. 2095). The original opinion contained no such intimation. The contrary is reflected in the studious effort to circum-

vent its binding effect as "the law of the case" and in the frank concession that "no doubt it would have been accepted as the law of the case on the same facts upon a retrial in the State Court, and ought to have been so regarded in the District Court" (R. 2076).

Despite the Texas Court's pronouncement in this very case, on all issues as between the old bank, J. T. Harrell and Petitioner, the Circuit Court resorts to the Texas Court's contemporaneous decision in *Q. A. & P. Ry. Co. v. Wichita State Bank & Trust Company, supra*, as indicating that the "Supreme Court of Texas would probably agree with our conclusions in view of what it has since done" (R. 2096).

As heretofore pointed out, a grave mistake was committed in treating the decision in the *Quanah* case as later in time than the case at bar. The Motion for Rehearing was overruled on written opinion in the present case on the same day that the opinion was delivered in the *Quanah* case. Each opinion expressly reaffirmed the principles laid down in the instant case. Furthermore, the *Quanah* case involved nothing more than straight deposits of bills of exchange payable to one Hawkins as Treasurer of the Q. A. & P. Ry. Co., to the personal account of said Hawkins, and his individual withdrawal and dissipation of the funds so credited. The Bank had no notice save from the form of the checks and the manner of their deposit. No part of the fund was received by the Bank. There was no system of transfers from a trust or corporate account to a personal account in the same Bank. These distinctions are carefully stressed in the Court's opinion—particu-

larly the fact that in the present case the bank "knowingly received a part of the fund to itself in payment of the trustee's individual debt to it." 127 Tex. 407; 93 S. W. (2d) 709.

It is firmly believed that the Supreme Court's decision in this case represents the only State law to be applied by the Federal Court after its removal. No other Texas case undertakes to repudiate or modify that decision. The Circuit Court's refusal to follow can not be reconciled with the mandate of this Court in *Erie Railway Co. v. Tompkins*, 82 U. S. 787, and *Ruhlin et al v. New York Life Insurance Co.*, 82 U. S. 823. That failure may not be excused by the Court's speculative conclusion as to what the Texas Court might say if the case were again before it for decision. Such admitted substitution of prophecy for precedent could hardly come within the requirement imposed by this Honorable Court in the *Ruhlin* case. It was there said:

> "The parties and the Federal Courts must now search for and apply the entire body of substantive law governing an identical decision in the State Court."

The question is important. Upon it depends the standard of care to be exercised by commercial institutions in Texas—whether that standard is to be ever passive or whether it becomes active upon notice, whether a bank once charged with notice of a trustee's infidelity may thereafter deal with him as before. The question involves the general commercial law of Texas, applicable to all banks in the handling of fiduciary ac-

counts. A vast amount of money is involved. Suit was for $200,000.00, made up of numerous checks over a long period of time. It is important that there be not a federal rule of decision for Texas and another and different rule by the Supreme Court of the State. Only this Court can resolve the confusion that necessarily results.

For the above reasons, your Petitioner prays for the issuance of a Writ of Certiorari under the Seal of this Court directed to the United States Circuit Court of Appeals for the Fifth Circuit, commanding said Court to certify the above cause to this Court for review and a proper determination of the questions involved, and for any and all other relief to which it may be entitled in the premises.

The mandate having issued, prayer is made that further proceedings be stayed.

Respectfully submitted,
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